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No. 371

# In the Supreme Court of the United States

OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE, *Petitioner,*

*vs.*

JOHN H. SMITH, *Respondent.*

## RESPONDENT'S PETITION FOR REHEARING AND MOTION TO WITHHOLD ISSUANCE OF MANDATE

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OCTOBER TERM, 1944

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COMMISSIONER OF INTERNAL REVENUE, *Petitioner,*

*vs.*

JOHN H. SMITH, *Respondent.*

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## RESPONDENT'S PETITION FOR REHEARING

Comes now the Respondent in the above entitled cause and respectfully petitions the Court for a rehearing of the above cause and the reconsideration of the record and decisions herein upon the following grounds:

1. The opinion of the above Court appears to be premised upon a purported finding of fact made by the Tax Court. The Circuit Court of Appeals, in its decision and after scrutiny of the record, held that there was no "basis for finding that the option was intended to enable Petitioner to make a 'bargain purchase'."

Respondent respectfully submits that the Tax Court made no finding of fact but ruled only upon the question of law. The opinion of the Tax Court (R. 29) states that the Respondent's failure to report income in

the taxable years "was due to an honest mistake of law" and also stated (R. 34):

> "The transaction between Western and Petitioner was of such nature that the effect in the taxable year upon Petitioner's income tax liability *involved a construction of law* which, in itself, is difficult. We are satisfied from the record that Petitioner's failure to report the excess of the fair market value of the stock over the option price as income was due to an honest misunderstanding of law and not to negligence or intentional disregard of regulations." (Emphasis ours.)

We respectfully submit that this Court should re-examine the testimony in this case. From an examination of the testimony, we do not see how the Court can come to any other conclusion than that the parties intended that the option itself should be the sole remuneration and that any increase in value of the stock should not be compensation.

2. The evidence in the record conclusively shows that the option itself was the only form of compensation given. The services of John H. Smith as an employee subsequent to 1934 were in no way connected with this option (R. 74, 75, 95). The testimony shows that the option agreement between these parties was just the same as if it were between strangers (R. 95). Even on cross-examination the testimony of Mr. Smith was as follows (R. 107):

"Q. Now, *the option*, however, to buy the stock was given to you for services rendered, is that correct,—is it not?

"A. That is correct." (Emphasis ours.)

The record unqualifiedly shows that the Western Cooperage Company did not look upon the increase in values as compensation to Mr. Smith. The testimony of M. D. Carter, accountant for Western Cooperage Company (R. 133, 134) is as follows:

"Q. And in the year 1938 was there any reflection in the records of the Western Cooperage Company of any income or salary or compensation paid to Mr. Smith which in any way reflected the value,—market value, or any other value of this common and second preferred stock? A. No.

"Q. Was there any deduction taken in any way in their income tax return for 1938 or 1939? A. There was not.

"Q. Representing any form of compensation to Mr. Smith by reason of his purchase of this stock? A. No, there was not."

The uncontradicted testimony in the case therefore shows that neither party intended that any increase in value was to be compensation. It is significant in this case that the employer did not take any deduction on its own tax return for the difference between the option price and the market value as compensation paid to an employee. If it was compensation to John Smith, it

would also be deductible as an operating expense by the employer.

3. The opinion of the above Court indicates that the Court viewed this transaction as being two separate purchases, one in 1938 and one in 1939. The record shows that from December 10, 1934, to March 21, 1938, John H. Smith had only an option to purchase the right to receive. On March 21, 1938, he exercised this option and thereby *purchased in 1938* all of the stock which he thereafter received over a period of four years (R. 87, 88, 89, 90). The deliveries of these shares in the respective years were as follows:

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| 1938 | 33,759 shares |
| 1939 | 12,404 " |
| 1940 | 17,356 " |
| 1941 | 10,858-1/24 shares |
| Total | 74,377-1/24 shares |

As of March 21, 1938, John Smith paid the full purchase price of $7,437.70 as the consideration for all of the shares. After March 21, 1938, John H. Smith no longer held an option, but was the absolute purchaser of the shares in the year 1938. The only thing remaining to be done was the delivery thereof, which was done in the respective years. The tax deficiencies for 1940 and 1941 were not considered in this record as they had not yet been proposed at the time of the trial before the Tax

Court. The Petitioner submits that if the decision of the Tax Court is not to be reversed, at least it should be modified, to show this transaction as consummated in the year 1938 when the total purchase price was actually paid. In other words, if a tax is to be imposed by reason of the increase in value, the entire tax should be imposed in the year 1938 and not spread over the years 1938, 1939, 1940 and 1941. At least in 1938 John H. Smith became an absolute purchaser as distinguished from an optionee.

At the time Mr. Smith exercised the option in 1938 by payment of the full option price, he was vested with the right to receive the stock covered by the option; he also elected to and did purchase such stock. It is true that he did not then take delivery of all of such stock, but he then *purchased* said stock and acquired the right to have all of such stock delivered to him. At the time of the exercise of the option, Mr. Smith exhausted the option and terminated its value, and, under the theory as set forth in the opinion of this Court, the compensation to Mr. Smith should be the value of the stock acquired at the time of the exercise of the option, less the option price paid by Mr. Smith.

The Western Cooperage Company should be permitted, under such theory of the opinion of this Court, to claim a deduction in its operating expenses, for the

compensation paid Mr. Smith, which would be the value of the stock, at the time of the exercise of the option, less the option price thereof.

But, somewhere, there must be a cut-off date for tax accounting with respect to both the tax returns of Mr. Smith, the employee, and of the Western Cooperage Company, the employer, and that date must be the same date for each of such returns. The Circuit Court of Appeals found that such cut-off date was the date of the option. The opinion of this Court, unless modified, would determine that such cut-off date was, for Mr. Smith, the date of the delivery of each parcel of stock, long after the termination by exercise, of the option. If such date is the proper cut-off date for Mr. Smith, then it must also follow that such date is the proper cut-off date for his employer. Whatever is charged on that date against Mr. Smith as income for services must also be allowed, under such opinion, as a deduction, as of the same date, in the return of his employer the Western Cooperage Company, as compensation for his services as an employee.

Certainly that cut-off date should not be extended beyond the date of the termination of the option, which option represented the only value given to Mr. Smith for his past services. To leave this matter open, with no assurance as to the date of the cut-off in the respec-

tive returns of Mr. Smith, the employee, and of the Western Cooperage Company, the employer, will lead to all kinds of complications. For instance, let us assume that the stock was worth $10.00 per share at the date of the exercise of the option, and that war-time income taxes then prevailed; would Mr. Smith be permitted to put off the day of delivery to him of the stock until post-war lower taxes might be in effect? Or, let us assume that the value of the stock was higher, at the time of the exercise of the option, than justified in the forecast and opinion of Mr. Smith; would he be permitted to delay delivery until the value might be reduced to what he considered to be a justifiable value as a tax base?

Or, assuming that Mr. Smith, after the exercise of the option, sold such stock and delivery to his purchaser was indefinitely delayed; what would be the cut-off date in the return of Mr. Smith and what would be the cut-off date in the return of his employer, Western Cooperage Company?

This line of argument, if logically pursued in the application of the theory of the opinion of this Court, must lead to the following conclusions, to-wit:

(a) That the option was the "value" which was delivered to Mr. Smith for his past services;

(b) That the value of the stock *at the time of the exercise of the option*, less the option price

thereof, represented the dollar and cents value of that option;

(c) That at the time of the exercise of said option, Mr. Smith was chargeable with the then value of the stock purchased in the exercise of said option as compensation for his services, and the Western Cooperage Company was likewise then entitled to take such value as a deduction in its operating expenses.

4. The Court, in its opinion, made no mention of the fact that this option ran, not only to John H. Smith, but to his heirs and assigns. This option contract was assignable. If John H. Smith had assigned this contract, the increase in value certainly could not have been considered as compensation in the hands of his assignee. If John H. Smith had died prior to the time he exercised his option, his heirs could have enforced the option. It cannot be said that his heirs were employees or that any increase in value was compensation to his heirs. This portion of the agreement is a further manifestation of the intent of the parties that the increase in value was never intended as compensation by any of the parties to the transaction.

5. The Court, in its opinion, made no mention of the distinction to be drawn under the Tax Act between one who purchases from his employer pursuant to an "arm's length" transaction and a similar "arm's length" transaction between strangers. In this case the Respondent made an "arm's length" transaction with his

employer under which the increase in value was not intended as compensation and the Respondent is taxed upon the increase in value as ordinary income. An identical transaction between two strangers would result in tax, not at the time of acquisition, but at the time of sale and the tax would be on the basis of a capital gain or loss. We respectfully submit that this is not only unjust to this taxpayer but is adding confusion to the equitable administration of the tax law.

6. We also respectfully submit that the revenues of the Government will be greatly impaired by this decision for the reason that corporate employers who have or will give to employees options similar to the one in the instant case, will welcome the opportunity to have a further deduction from their corporate income and thereby reduce the corporate tax, the maximum rates of which are in excess of those on personal incomes.

## CONCLUSION

We respectfully submit that the Court should re-examine the testimony in this case and grant a rehearing herein. In the event that the decision of the Circuit Court of Appeals cannot be affirmed, this Court at least should modify the decision of the Tax Court and hold that the actual purchase of all of the shares referred to in the option was consummated in 1938, when the purchase was actually made by payment of the consideration therefor, and all of the gains on the 74,377 shares taxed in 1938. In the alternative, we respectfully submit that the matter should be remanded to the Tax Court for retrial. This would enable the Tax Court to consider at the same time, the tax deficiencies for 1940 and 1941 in conjunction with 1938 and 1939, and thereby consider the whole transaction.

Respectfully submitted,

CLARENCE D. PHILLIPS.

*Of Council:*

GRIFFITH, PECK, PHILLIPS & NELSON,

March, 1945.

I, Clarence D. Phillips, attorney for Respondent in the above cause, do hereby certify that the foregoing petition for Rehearing is presented in good faith and not for delay and that this certificate is made pursuant to Rule 33 of the Rules of the above Court.

CLARENCE D. PHILLIPS,
*Attorney for Petitioner.*

## In the Supreme Court of the United States

**OCTOBER TERM, 1944**

COMMISSIONER OF INTERNAL REVENUE, *Petitioner,*

*vs.*

JOHN H. SMITH, *Respondent.*

### MOTION TO WITHHOLD ISSUANCE OF MANDATE

Respondent herein moves the Court for an Order enlarging the time for the issuance of mandate and that the issuance of mandate be withhled until the disposition of the within Petition for Rehearing.

*Attorney for Respondent.*
CLARENCE D. PHILLIPS.

# SUPREME COURT OF THE UNITED STATES.

No. 371.—October Term, 1944.

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| Commissioner of Internal Revenue, Petitioner, vs. John H. Smith. | On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit. |

[February 26, 1945.]

Mr. Chief Justice Stone delivered the opinion of the Court.

Respondent's employer gave to him, as compensation for his services, an option to purchase from the employer certain shares of stock of another corporation at a price not less than the then value of the stock. In two later tax years, when the market value of the stock was greater than the option price, respondent exercised the option, purchasing large amounts of the stock in each year. The question for decision is whether the difference between the market value and the option price of the stock was compensation for personal services of the employee, taxable as income in the years when he received the stock, under § 22(a) of the Revenue Act of 1938, c. 289, 52 Stat. 447, and § 22(a) of the Internal Revenue Code, 26 U. S. C. § 22(a).

Upon a petition to review the Commissioner's finding of a tax deficiency against respondent for those years, the Tax Court sustained the Commissioner. The Court of Appeals for the Ninth Circuit reversed, 142 F. 2d 818, holding that there was no finding and no evidence to support a finding, that the option was intended to enable respondent to make a "bargain purchase" or that the stock was issued to him as compensation for services. It concluded that the exercise of the option was a mere purchase of a capital investment which could result in taxable income only upon sale of the stock. We granted certiorari, 323 U. S. —, on a petition which asserted conflict of the decision below with the decision of the Court of Appeals for the Sixth Circuit in *Connolly's Estate v. Commissioner*, 135 F. 2d 64.

The Tax Court found that for many years, and at all relevant times, respondent was employed by the Western Cooperage Com-

pany. In 1934 Western took over the management of the Hawley Pulp and Paper Co. pursuant to a plan for its reorganization. Hawley was then in financial difficulties, with an indebtedness amounting to $2,790,150. Under its contract with Hawley, Western was to retire annually a certain amount of Hawley's indebtedness. In the event of success in this undertaking, and when the amount of Hawley's indebtedness had been reduced by the sum of $1,400,000, Western was to receive specified amounts of the Hawley Company's capital stock as compensation for the services thus rendered.

Respondent, in the course of his employment by Western, was active in the reorganization of the Hawley Company. As compensation for his services, the president of Western, in December 1934, gave respondent an oral option to purchase a part of the Hawley stock, to be acquired by Western under its contract. This action was confirmed by resolution of the Board of Directors of Western, pursuant to which Western, as of December 10, 1934, and "in consideration of services rendered" by respondent prior to that date, agreed in writing to sell to respondent at his option, at ten cents a share, a specified proportion of such shares of common stock as it might be entitled to receive under its contract with Hawley. On March 18, 1938, Western became entitled to the stipulated number of shares of the Hawley stock as provided by the contract with Hawley. In that and the following year respondent, by the exercise of his option, acquired from Western large amounts of the stock on payment of the option price.

The Tax Court found that at the date of the option the market price of the stock did not exceed the option price, but that in 1938 the market value of the stock then acquired by respondent exceeded its option price by $81,021, and the value of that acquired in 1939 exceeded the option price by $71,663. The court found from the option itself, the resolution of Western's Board of Directors, and from petitioner's own testimony, that "Western gave the option to petitioner [respondent here] as compensation for services rendered in effecting the reorganization plan of Hawley." It held that the excess of the market value of the shares over the option price in the years when the shares were received by respondent, was compensation for his services, taxable as income in those years.

Since the Tax Court found that the market price of the stock on the date of the option did not exceed the option price, it is evident that its finding that the option was given as compensation for respondent's services, had reference to the compensation to be derived from exercise of the option after the anticipated advance in market price of the stock. The option could be exercised only ing at the end of the first sentence on page 2 of the opinion: "Respondent testified that if the option could have been sold at the time he received it, it would have been for only a 'negligible' or 'nominal' amount. He has never contended that the option itself had value when given and there was no finding by The Tax Court that it then had value. The Tax Court, in stating the principle which it deemed applicable to the present case, quoted from Estate of Edward J. Connolly, 45 B. T. A. 374, as follows: 'If the options had never been exercised the optionees would never have received any additional compensation'."

Treasury Regulations 103, Art. 19.22(a)-1.

Section 22(a) of the Revenue Act defines "gross income" subject to the Act as including "gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid. . . ." Treasury Regulations 101, Art. 22(a)-1 provides: "If property is transferred . . . by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such . . . employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered. . . ."

Section 22(a) of the Revenue Act is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected. *See Old Colony Trust Co.* v. *Commissioner*, 279 U. S. 716, 729. The regulation specifically includes in income, property "transferred . . . by an employer to an employee, for an amount substantially less than its fair market value," even though the transfer takes the form of a sale or exchange, to the extent that the employee receives compensation.

In certain aspects an option may be spoken of as "property" in the hands of the option holder. Cf. *Helvering* v. *San Joaquin*

*Fruit and Investment Co.*, 297 U. S. 496, 498; *Shuster* v. *Helvering*, 121 F. 2d 643, 645. When the option price is less than the market price of the property for the purchase of which the option is given, it may have present value and may be found to be itself compensation for services rendered. But it is plain that in the circumstances of the present case, the option when given did not operate to transfer any of the shares of stock from the employer to the employee within the meaning of § 22(a) and Art. 22(a)-1. Cf. *Palmer* v. *Commissioner*, 302 U. S. 63, 71. And as the option was not found to have any market value when given, it could not itself operate to compensate respondent. It could do so only as it might be the means of securing the transfer of the shares of stock from the employer to the employee at a price less than their market value, or possibly, which we do not decide, as the option might be sold when that disparity in value existed. Hence the compensation for respondent's services, which the parties contemplated, plainly was not confined to the mere delivery to respondent of an option of no present value, but included the compensation obtainable by the exercise of the option given for that purpose. It of course does not follow that in other circumstances not here present the option itself, rather than the proceeds of its exercise, could not be found to be the only intended compensation.

The Tax Court thus found that the option was given to respondent as compensation for services, and implicitly that the compensation referred to was the excess in value of the shares of stock over the option price whenever the option was exercised. From these facts it concluded that the compensation was taxable as such by the provisions of the applicable Revenue Acts and regulations. We find no basis for disturbing its findings, and we conclude it correctly applied the law to the facts found. Its decision is affirmed, and the judgment of the Court of Appeals below, reversing it, is

*Reversed.*

Mr. Justice ROBERTS is of opinion that the judgment should be affirmed for the reasons stated by the Circuit Court of Appeals, 142 F. 2d 818.

# SUPREME COURT OF THE UNITED STATES.

No. 371.—October Term, 1944.

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| Commissioner of Internal Revenue, Petitioner, *vs.* John H. Smith | On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit. |

[April 9, 1945.]

Mr. Chief Justice Stone delivered the opinion of the Court.

Respondent, on motion for rehearing in this Court, for the first time contends that if he is taxable at all after the receipt of the option in 1934, he is taxable as of the date in March, 1938, when he exercised his option, and not when he received the stock in later years. The only later year in question is 1939 in which he received a substantial part of the stock. Before the delivery in 1939 and after the exercise of the option in 1938 there was a substantial increase in the value of the stock. He argues that the tax should be measured by the value of the stock in 1938 less the option price. Cf. *Palmer* v. *Commissioner*, 302 U. S. 63, 73.

It is true that respondent gave notice of his exercise of the option and paid the option price in 1938. But at that time Western, under its contract with Hawley, had a right to receive but a part of the stock subject to respondent's option; its right to the remainder was conditioned upon its making further payments of Hawley's indebtedness. Respondent's option contemplated delivery to him of Hawley's stock only if and when Western became entitled to receive the stock from Hawley. In fact deliveries of the stock were made to respondent upon each occasion only a day or two after Western received it from Hawley.

The Tax Court [illegible] and that respondent received compensation "when [he] exercised his option and received the stock." We take it that the Tax Court regarded fulfillment of the conditions upon the right of Western to receive the stock, and therefore of the conditions upon the derivative right of respondent to receive it under his option, as prerequisite to the effective exercise of the option; and that the taxable compensation to petitioner intended to be secured by the option was in fact received by respondent as

and when the shares of stock were delivered to him, since prior to that time there was no certainty that he would receive the stock. This conclusion of the Tax Court finds ample support in the record, and we concur in it.

We do not have before us a case where by the exercise of an option in one year the taxpayer acquires an unconditional right to receive the stock in a later year. We express no opinion upon the question whether, in such a case, compensation would be received and would be taxable in the earlier or the later year.

The petition for rehearing is denied.

Mr. Justice ROBERTS adheres to his dissent.